

4. HARING AND ROHLFS

The declaration of Drs. Haring and Rohlf's differs in tone and recommendations from the other payphone coalition filings. While accepting the role of geography in differentiating payphones (Haring and Rohlf's, p. 4), Drs. Haring and Rohlf's describe the payphone industry as one exhibiting low barriers to entry. This, of course, is true only in the sense that there are many PSPs. There are also many cable television operators in the United States. The difficulty is that the relevant geographic scope of a payphone is not the United States, and may be only tens of feet in diameter. The existence of certain "high quality" sites – the authors point to prisons and mass-transit facilities such as airports – is regarded as unimportant due to wireless phones and public complaints about excessive prices. Further, the operators of these facilities are regarded as public spirited and unwilling to exploit their monopoly positions (Haring and Rohlf's, p. 5).¹⁵ Such an assertion can hardly be taken seriously by an agency enjoined to serve the public interest.

One may question the efficacy of cellular phones as a substitute for payphones, and we did so in our initial filing. The claims that benevolence or public pressure will effectively check price gouging are novel, and appear to have no support in recent experience.

Drs. Haring and Rohlf's, in contrast to other affiliates for the payphone coalition, do take the geographic monopoly issue seriously, and they suggest that, "special or extraordinary circumstances may deserve special treatment" (p. 6). Their argument that "...price controls that prevent locational rent extraction/monopoly exploitation at certain public facilities may well cause shortages of supply..." (p. 6) is curious, to say the least, since the rent is, in this case, a return due to monopoly power rather than a social cost of the payphones. A reduction in the monopoly site rent should have no impact on the willingness of a PSP to install a payphone at a particular location, nor on the supply of that site when alternative uses offer competitive returns.

Drs. Haring and Rohlf's suggest the efficacy of a model of differentiated product monopolistic competition, with geographical location serving as the (primary) differentiating device. Analyses of this type, with free entry, lead to zero profit equilibria but prices in excess of incremental costs. In fact, Haring and Rohlf's appear to argue in favor of an inverse elasticity pricing rule (p. 8), a form of Ramsey pricing associated with Baumol, Bailey, and Willig's famous 1977 paper, "Weak Invisible Hand Theorems on the Sustainability of Prices in a Multiproduct Natural

¹⁵ For example, Metro-tel, a private payphone operator, was forced to remove up to 3,400 payphones from Olympic sites by the Georgia Public Service Commission due to (in part) excessive rates including a \$1.75 rate for a three minute local call. Note that it was regulation, not altruism, that responded to these exorbitant charges – regulations that are no longer in place (Independent Pay Phone Operator Loses Contract to Serve Summer Olympics." *Communications Daily*, July 9, 1996).

Monopoly."¹⁶ Similar results appear in Baumol, Panzar, and Willig (1982), and Tirole (1989)¹⁷. However, this sort of analysis is not useful in the present context for several reasons. First, differentiation is not ordinarily contemplated in the contestability literature. Second, implementing such rules requires extraordinarily detailed information on market demands, perhaps for every payphone market. Third, site rents form a kind of residual input cost to PSPs, a circumstance not contemplated in this literature.

Underlying this analysis is the notion, discussed by Drs. Haring and Rohlfs on page 3 of their declaration, that payphones "...display both economies of scale and scope." While this circumstance (as presented by Drs. Haring and Rohlfs) might seem inconsistent with the assertion that there are low barriers to entry in this industry, it is important to note that the cost properties of a payphone and the cost properties of a PSP's technology are not the same thing. Numerous costly business functions are associated with coin operations (e.g., collecting, sorting, repairs of vandalism) that refer to the population of a PSP's payphones. If one were to uncritically cite the fixed costs of a payphone as proof of the subadditivity of costs in the payphone industry, one might conclude natural monopoly conditions exist, necessitating further regulation. This serves, of course, as a further reminder of the old maxim that deregulation and competition are not the same thing.

Drs. Haring and Rohlfs, along with other payphone coalition affiliates, criticize the use of bottom-up cost models on the familiar grounds that such models do not produce per call costs. This "failing" results in the necessity of dividing costs by some numbers of calls to generate average costs per call. Yet, the numbers of calls depend on the numbers of phones, which in turn depend on the compensation to dial around. Issues of this sort are very old in the regulatory literature, and are frequently encountered in "fully distributed cost" (FDC) pricing methodologies. The proposals of the coalitions' economists do not avoid this difficulty any more than a bottom-up cost calculation. Both require a per call calculation. However, the use of observed coin rates in an avoided-cost methodology suffers from worse failings, both by capitalizing monopoly rents and necessitating a division of per month type costs by some number of calls (prevailing under monopoly) to generate a per call dial around compensation rate. The goal of any regulatory policy should be to duplicate competition: establish prices equal to those that would prevail if competing PSPs located their phones side by side.

¹⁶ American Economic Review, June 1977.

¹⁷ W. Baumol, J. Panzar, and R. Willig, Contestable Markets and the Theory of Industry Structure, New York: Harcourt Brace Jovanovich, 1982; J. Tirole, The Theory of Industrial Organization, Cambridge, Ma.: MIT Press, 1989.

5. CONTRADICTIONS

The declarations of Drs. Kahn, Hausman, Becker, Haring and Rohlfs are in agreement that: (i) the recent, widespread forty percent increase in coin rates establishes the competitive price at \$0.35; (ii) this price should be used to calculate dial around compensation. Unfortunately, the competitive models underlying these various filings are quite inconsistent on the appropriate methodology to use in setting dial around rates. Drs. Haring and Rohlfs argue for an inverse elasticity based procedure that would produce a very small discount from observed coin rates. Dr. Hausman argues that inverse elasticity pricing is most efficient, but suggests an avoided cost rule instead. An elasticity rule leads to product margins that differ based on demand elasticities. Dr. Becker, on the contrary, suggests that the margins earned on dial around calls should equal those earned on coin calls. Dr. Kahn argues for an avoided cost rule, but wishes to force dial around users to pay a portion of the costs of coin operations.

The inconsistencies in these positions arise, we believe, from different conceptualizations of how competition works in the payphone industry, and consequently which welfare standard is appropriate. Contestability type standards lead to Ramsey type rules, and allow consideration of economies of scale and scope. Conventional competitive analysis leads to avoided cost rules. All of these analyses, to be useful, must be correct about one thing: payphone markets are competitive (or, alternatively, contestible) so that observed prices can be used to do cost calculations. Further, site rents must be assumed to be social costs if average (rather than marginal) rents are used in costing dial around service. We have argued, and supported with evidence, that neither of these conditions applies here. The Court, in its remand of the Second Order, also seems reluctant to believe that coin prices can be used to do cost calculations.

Many commentators have noted the widespread forty percent increase in coin prices since general deregulation of local coin rates. The payphone coalition affiants must interpret this huge increase as an adjustment to competitive (i.e., just compensatory) prices. There are only two possible explanations for this increase available to the payphone coalition. First, the old rates were below cost, so payphones previously lost money. This explanation would simultaneously require evidence that (i) almost 2,000,000 payphones in the U.S. were installed under duress by regulated LECs, and (ii) no private phones were installed under the regulated prices since their prices were, by assumption, not compensatory. Furthermore, regulations to keep out private payphones would not have been needed. Alternatively, one could argue that costs have risen forty percent since deregulation. Such a cost increase could not be blamed on site rents (unless those rents represent newly capitalized monopoly returns) since it is very unlikely the alternative uses of site space suddenly became much more valuable due, for example, to a mania for vending machine products. We are unaware of non-site rent cost changes of such significance.

Plainly, then, the forty percent increases in local coin rates so widely observed are difficult to reconcile with (traditional) competition in the payphone markets. On the other hand, it requires little suspension of disbelief to argue that the forty percent price increase is the first adjustment of a recently deregulated industry composed of numerous, small, geographic monopolies. Thus, we expect (i) further price increases; (ii) increasing variation in coin rates by sites; and (iii) rising site rents.

IV. CONCLUSION

It is undeniable that a large percentage of a payphone operator's costs are monopoly rents paid to premise owners as commissions. These monopoly rents are not a social cost and should not be included in a regulated rate intended to mimic a competitive outcome. It is untenable that the recent forty percent price increase on the local coin rate is required to make existing payphone sites profitable. Existing sites are presumably profitable by definition. It is indisputable that commissions and payphone rates are driven up by the presence of a large number of payphone providers and low barriers to entry. Statements by payphone operators have confirmed as much. The evidence points strongly toward monopoly, not competition, in the payphone industry.

There has been no persuasive evidence presented in this proceeding or any prior proceeding that indicates competitive forces can be relied upon to constrain payphone rates. Nor has there been any persuasive evidence that the now predominant \$0.35 coin rate is a competitively determined market price. There is nothing in the declarations submitted by Drs. Becker, Kahn, Hausman, and Haring and Rohlfs, which would lead us to alter our conclusions about the nature of competition in the payphone industry. There is little doubt that the \$0.35 local coin rate overstates the rate that would obtain in a competitive market with different PSPs placing phones side-by-side. Thus, any compensation calculation based on the coin rate, regardless of the method used, will be flawed.

The inability to use coin price as the basis for calculating competitive dial around compensation rates implies that the FCC should adopt a bottom-up cost methodology for this purpose.

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